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No. 351

In the Supreme Court of the United States

OCTOBER TERM, 1930

A. JAMES ECKERT, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 8–10) is reported in 17 B. T. A. 263. The opinion of the Circuit Court of Appeals (R. 15–17) is reported in 42 F. (2d) 158.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 9, 1930. (R. 18.) A petition for rehearing was denied July 7, 1930. (R. 18.) Petition for certiorari was filed August 14, 1930, and certiorari was granted on October 20, 1930.

(R. 19.) The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1925 petitioner and another individual were required by a bank to substitute their own joint note for notes of a corporation which they had endorsed. At this time the corporation had no assets, had discontinued business, and was in process of dissolution. Petitioner did not, in 1925, pay any cash to the bank on the note which he made in that year. Petitioner's return was filed upon the cash basis.

In computing his net income for that year, was petitioner entitled to deduct any portion of the notes as a "loss sustained during the taxable year" or a "debt ascertained to be worthless and charged off within the taxable year," under Section 214 (a) (4) or (7) of the Revenue Act of 1926?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9, 10, 23, 26, 69.

TITLE II

SEC. 200. When used in this title—

* * * * *

(d) The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212 or 232. The deductions

and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed under section 212 or 232, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. (U. S. C. App., Title 26, Sec. 931.)

SEC. 212. (a) In the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by sections 214 and 206.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (U. S. C. App., Title 26, Sec. 953.)

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

* * * * * *

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part; * * *. (U. S. C., App., Title 26, Sec. 955.)

SEC. 286. This title shall take effect as of January 1, 1925, except that section 257 and sections 271 to 285, inclusive, and this section, shall take effect on the enactment of this Act.

Treasury Regulations 69:

ART. 23. *Bases of computation.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. (See sections 200 (d) and 213 (a).) For instance, in any case in which it is necessary to use an inventory, no

accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See articles 51 and 52.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see article 1615.) * * *.

STATEMENT

The record does not contain the evidence. The Board of Tax Appeals made the following findings of fact (R. 7–8):

Prior to 1922 the petitioner and William A. Ainsworth were engaged in business as partners under the firm name of Electric Refrigeration Company. In 1922 they organized a corporation under the name of Electric Refrigeration Co., Inc., which acquired all of the assets and assumed all of the liabilities of the partnership, including certain notes, totaling $25,419.65, payable to and held by the Citizens Trust Company of Utica, N. Y., for money loaned to the partnership. The bank subsequently accepted notes executed by the corporation for the partnership notes. Between 1922 and 1925 the corporation issued several additional notes in the amount of $19,375.25, in favor of the same bank for loans. All of the notes issued by the corporation in favor of the bank were endorsed by the petitioner and Ainsworth.

In September, 1925, the bank made a demand upon the corporation for payment of the latter's notes. Subsequently, in 1925, the corporation discontinued business and proceeded to wind up its affairs. Its assets on dissolution were sufficient to pay only $600 on the notes. This amount was paid by the corporation in December, 1925, leaving an unpaid balance of $44,800, after charging about $5 to the personal account of the petitioner. Concurrently with this payment of $600 by the corporation the petitioner and Ainsworth delivered to the bank their joint note for $44,800 in settlement of their liabilities as endorsers of the corporation's notes, and in return received the corporation's notes stamped "paid." The notes were subsequently destroyed by the petitioner.

The liquidation of petitioner's liability as an endorser of the corporation's note did not involve the payment of any cash. The petitioner has never collected anything on the notes he and Ainsworth paid. He did not keep books of account. His return for the taxable year 1925 was filed on the cash basis.

The petitioner in his return for 1925 claimed a deduction of $22,400 on account of this transaction. The Commissioner declined to allow him any deduction on account of the transaction, basing his decision on the fact that no cash payment was made by petitioner during the taxable year.

The Board held that the petitioner was not entitled to a deduction of the amount claimed, either

as a loss or as a worthless debt of the corporation, and approved the Commissioner's determination. On appeal, this decision was affirmed by the Circuit Court of Appeals for the Second Circuit.

SUMMARY OF ARGUMENT

We concede that under the facts in this case the petitioner will be entitled to a deduction in the year in which he makes any payment on the note, but as his return was rendered on the cash basis he can not take a loss until he pays cash.

ARGUMENT

The petitioner seeks to deduct the amount of the note which he gave in 1925 under the provisions of Section 214 (a) (4) or (7) of the Revenue Act of 1926, p. 4, *supra*.

The Government does not contend that the taxpayer may not at some time be entitled to a deduction either on account of a bad debt or for a business loss.[1] The sole question in dispute is

[1] The Bureau of Internal Revenue has consistently ruled that an accommodation endorser or guarantor of a note may deduct the amount which he has to pay on account of his liability as endorser when the principal debtor becomes insolvent. Office Decision 556, published in 2 Cumulative Bulletin (January-June, 1920), p. 137; Solicitor's Memorandum 1298, published in 2 Cumulative Bulletin (January-June, 1920), p. 113; A. R. R. 479, published in 5 Cumulative Bulletin (July-December, 1921), p. 146; Income Tax Decision 2012, published in III–1 Cumulative Bulletin (January-June, 1924), p. 158; Income Tax Decision 2025, published in III–1 Cumulative Bulletin (January-June, 1924), p. 166. See also *Heyn* v. *Commissioner*, 4 B. T. A. 1256.

whether the taxpayer is entitled to the deduction in 1925, the year in which his note was given, or in the later year in which the taxpayer's liability on the note is actually liquidated by payment.

The petitioner reported his income on the cash basis. This basis requires that he report only actual receipts and deduct only actual disbursements, as distinguished from the accrual basis, which permits pecuniary obligations payable to or by the taxpayer to be treated as if discharged when incurred. All items are required to be treated with reasonable consistency. Article 23, Regulations 62, *supra*.

The worthless notes in the transaction here involved must be treated in such a manner as will be consistent with the cash receipts and disbursements method of accounting. If an inconsistency is established, it is competent for the Commissioner to correct the return to conform it to the system of accounting in fact adopted. *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92. In *United States* v. *Mitchell*, 271 U. S. 9, 12–13, where a similar provision of the 1918 Act was involved, this Court said:

> * * * it is the purpose of the Act to require returns that clearly reflect taxable income. That purpose will not be accomplished unless income received and deductible disbursements made are treated consistently. It was not the purpose of the Act to

> permit gross income actually received to be diminished by taxes or other deductible items disbursed in a later year, even if accrued in the taxable year. It is a reasonable construction of the law that the same method be applied to both sides of the account.

That case held that where an income-tax return for an estate is made on the basis of income actually received in the taxable year there may not be deducted the estate tax accruing in that year but paid in the following year.

When petitioner and his coëndorser gave their personal note in exchange for the notes of the corporation, they merely discharged one liability by the assumption of another, and the petitioner paid no cash. As he was on the cash basis, a deduction, whether for a loss under Section 214 (a) (4) or for a bad debt under Section 214 (a) (7), is permissible only for that taxable year in which he pays cash.

The situation here is unlike that in which a taxpayer pays off an obligation with the note of a third party. In such a case the note has value in the hands of the taxpayer; it may be an asset which in his hands is the equivalent of cash. As the Circuit Court of Appeals said (R. 17):

> The giving of a note does not constitute a cash payment. The obligation to pay the amount of the note may be as binding, for instance, as payment of taxes, but it has been determined that a taxpayer on a cash received and disbursed basis can not deduct taxes before they are actually paid. *United*

> *States* v. *Mitchell, supra.* Nor can a taxpayer, who subscribes to a charitable fund, deduct the subscription until he has paid it. *Mann* v. *Commissioner* (App. D. C. 1929), 35 F. (2d) 873. The taxpayer not having sustained a loss because he did not pay the note or any part thereof in the year 1925, the Commissioner properly held that he was not entitled to this deduction. * * *

See also *Blair* v. *First Trust & Savings Bank,* 39 F. (2d) 462 (C. C. A. 5th), certiorari denied, 282 U. S. xi, where it was held that where a bank made its return on the cash basis notes which it received as commissions for making loans were not income until the notes were paid.

That the petitioner is entitled to no deduction for the year 1925 is further shown by the fact that the note was a joint note signed by him and by his partner, Ainsworth. The petitioner seeks to deduct half of the face amount of this note as his share of the joint loss. But it is not certain that the petitioner will eventually pay half of the amount of the note. His liability as a joint maker of the note is for its entire face value. The petitioner may eventually have to pay the entire amount of the note, or it may develop that the partner, Ainsworth, will have to pay the entire amount of the note because of petitioner's insolvency or failure to pay his share. It does not appear in the findings that the petitioner's share of the liability on the joint note was one-half the

total. It may have been that as between the petitioner and Ainsworth, Ainsworth was primarily liable for the whole amount or some part of it, more or less than one-half. Under these circumstances we submit that it is plain that the petitioner, who made his return on the cash basis, may not properly deduct the liability evidenced by the note until that liability has been discharged by payment.

It is unimportant that a different result might have been reached if petitioner had pursued a different course. Even if it is true that the deduction might be allowed if the taxpayer had borrowed money on his own note and had then drawn a check to satisfy the note of the corporation, that is not this case. Tax liability often varies according to the form which the transaction actually takes. In *Weiss* v. *Stearn,* 265 U. S. 242, 254, this Court said:

> Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form.

See also *Miles* v. *Safe Deposit Co.,* 259 U. S. 247; *United States* v. *Phellis,* 257 U. S. 156, 172; *Remington Rand, Inc.,* v. *Commissioner,* 33 F. (2d) 77, 78, certiorari denied, 280 U. S. 591.

Nor does it militate against the force of our contention that a loss may become complete enough

for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. In *United States* v. *White Dental Co.*, 274 U. S. 398, a loss had been actually sustained through the seizure of property by the German sequestration, which left the corporation without right to demand its release or obtain immediate compensation. Here the situation is different, as the loss has been in fact postponed by the giving of a note and will not be complete until the note is paid.

In *S. R. Davis* v. *Commissioner*, 9 B. T. A. 755, the Board of Tax Appeals reached a conclusion similar to its decision in this case. However, that case was reversed by the Circuit Court of Appeals for the Seventh Circuit, without opinion, on October 24, 1928. Inasmuch as the court gave no reason for its decision, it is of little value as a precedent. Possibly the decision of that Circuit Court of Appeals may be accounted for by the fact that the notes in that case were not, like those here, worthless when received and that previous to the deduction they were taken into the taxpayer's investment accounts as an asset.

Another reason why the taxpayer is not entitled to deduction as a bad debt is because he did not "charge off" the debt within the taxable year. The debt did not arise until the taxpayer gave his note to the bank. Cf. *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243. At that time the debt was

worthless and the taxpayer had no asset which he could "charge off." The Circuit Court of Appeals said (R. 17):

> Nor is the taxpayer entitled to a deduction under clause 7 as a debt ascertained to be worthless and charged off during the year, because the debt was worthless when the taxpayer acquired it.

CONCLUSION

The decision of the Circuit Court of Appeals for the Second Circuit should be affirmed.

Respectfully submitted.

THOMAS D. THACHER,
Solicitor General.
G. A. YOUNGQUIST,
Assistant Attorey General.
CLAUDE R. BRANCH,
SEWALL KEY,
J. LOUIS MONARCH,
JOHN G. REMEY,
Special Assistants to the Attorney General.
ERWIN N. GRISWOLD,
Attorney.

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